INTERMEDIATE (IPC) COURSE

STUDY MATERIAL

PAPER : 5

ADVANCED ACCOUNTING

MODULE – 1

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

This Study Material has been prepared by the faculty of the Board of Studies. The objective of the study material is to provide teaching material to the students to enable them to obtain knowledge in the subject. In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein, they may write to the Director of Studies.

All care has been taken to provide interpretations and discussions in a manner useful for the students. However, the study material has not been specifically discussed by the Council of the Institute or any of its Committees and the views expressed herein may not be taken to necessarily represent the views of the Council or any of its Committees.

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A WORD ABOUT STUDY MATERIAL

Accounting constitutes a very significant area of core competence for chartered accountants. The paper of 'Advanced Accounting' at Intermediate (IPC) level concentrates on conceptual understanding of the crucial aspects of accounting.

This paper will acquaint you with the basic concepts, theories and accounting techniques followed by few different entities and expects you to gain working knowledge of few more professional standards and application of accounting principles to different practical situations.

The study material deals with the conceptual theoretical framework in detail. This Study Material has been designed having regard to the needs of home study and distance learning students. The students are expected to cover the entire syllabus and also practice solving the questions given in the practice manual on their own.

The main features of the study material as under:

- The entire syllabus has been divided into Eight chapters.
- In each chapter, learning objectives have been stated. The learning objectives would enable you to understand the sequence of various aspects dealt within the chapter before going into the details so that you know the direction of your studies.
- In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations and practical problems. You should go through the chapter carefully ensuring that you understand the topic and can tackle the exercises.
- Many illustrations have been included in each chapter of the Study Material.
- In this revised study material, sincere efforts and care has been taken to incorporate the relevant amendments.
- ***The Study Material has been revised in line with the relevant sections of the Companies Act, 2013 which have come into force.***
- Flow charts have been inserted in Chapters at appropriate places for quick reference of students.

- Any theoretical additions made in the chapters have been highlighted in bold and italics while practical illustrations have been highlighted with grey shading in the Study Material for easy identification and quick reference.
- In this revised edition, efforts have been taken to standardize the format of the solutions to the practical problems as far as possible.
- Feedback form is given in the study material wherein students are encouraged to give their feedback/suggestions.

From November, 2015 examination and onwards the topic "Financial Statements of Electricity Companies" has been excluded from the syllabus, therefore, the same has been removed from the Study Material.

These features would add value to the study material and aid the students in the learning process. In case you need any further clarification/guidance, you may send your queries at; seema@icai.in, shilpa@icai.in; asha.verma@icai.in.

SIGNIFICANT ADDITIONS/MODIFICATIONS IN 2015 EDITION OVER 2014 EDITION

Chapter no./unit no.	Name of Chapter/	Name of Unit	Section/ Sub-section	Changes
Chapter 2	Accounting Standards		2.1 AS 4: Contingencies and Events Occurring After the Balance Sheet Date	Illustration 4 added
			2.2 AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	Illustration 8 added
			2.3 AS 11: The Effects of Changes in Foreign Exchange Rates	Illustration 10 added
				Applicability of Para 46 for Entities other than Companies added
			2.5 AS 16: Borrowing Costs	Illustration 21 added
			2.8 AS 26: Intangible Assets	Illustration 34 added
			2.9 AS 29: Provisions, Continent Liabilities and Contingent	Illustration 35 added

			Assets	
Appendix III	Accounting Standards		AS 11 "The effects of changes in foreign exchange rates"	Para 46 for Entities other than Companies added at the end of the Standard.
Chapter 3- Unit 2	Advanced Issues in partnership Accounts	Amalgamation, Conversion and Sale of Partnership Firms	2.2 Conversion of partnership Firm into Company	Illustration 9 added
Chapter 4- Unit 1	Company Accounts	ESOP and Buy back of Shares	1.1 Employees Stock Option Plan	Para amended
Chapter 4- Unit 4		Amalgamation and Reconstruction	4.3 Advanced Problems	Illustration 14 added
Chapter 5 – Unit 1	Financial Statements of Insurance Companies	Introduction to Insurance Business	1.6 Insurance Regulatory and Development Authority Act, 1999 (Amendments)	Matter added
Chapter 5 – Unit 3		Financial Statements of Insurance Companies	3.5 Preparation of Financial Statements	Illustration 3 added
Chapter 6- Unit 1	Financial Statements of Banking Companies	Relevant Provisions of the Banking Regulation Act	1.10 Liquidity Norms	Amended
Chapter 6- Unit 3		Capital Adequacy Norms	3.1 Capital Frameworks of Banks in India	Amended
Chapter 6- Unit 4		Income Recognition, Classification of Assets and Provisions	4.2 Classification of Bank Advances	Matter added under para on Reschedulement / Restructuring /Renegotiation of Advances

			4.3 Provisions	Rate of provisioning for Non-performing Assets amended. Matter related to principle for creation of floating provisions and Interest Suspense Account added.
			4.4 Classification of Investments	Para related to Held-to-Maturity, (HTM) amended
Chapter 7	Departmental Accounts		8. Miscellaneous Illustrations	Illustration 7 added
Chapter 8	Branch Accounts		5. Accounting for dependent Branches	Illustration 3 added

STUDY PLAN – KEY TO EFFECTIVE LEARNING

Understand the syllabus

To start your preparation for the subject, it is necessary to understand clearly what is to be studied, from where to be studied and then how to be studied. Let's start with the first step in the process of your preparation. At the initial stage of preparation, one should study the syllabus carefully; also try to understand the relationships between various topics and the depth of the study required in different topics. The study material of Paper 5 'Advanced Accounting' is divided into nine chapters/topics based on the syllabus. The topics covered under this paper can be comprehended in the following manner:

Category	Name of the chapters
Topics on Accounting Standards	Chapter 1 Framework for Preparation and Presentation of Financial Statements Chapter 2: Accounting Standards
Partnership form of business	Chapter 3: Advanced issues in Partnership Accounts including issues related with LLP
Company form of business	Chapter 4: Company Accounts
Industry specific Financial statements	Chapter 5: Financial Statements of Insurance Companies Chapter 6: Financial Statements of Banking Companies
Accounting for Special Transactions	Chapter 7: Departmental Accounts Chapter 8: Accounting for Branches including Foreign Branches

Gather the course-ware to study

Once you acquaint yourself with the syllabus, the next step is to gather the knowledge inputs which have been provided by the Board of Studies, to study the paper.

1. **Study Material**
2. **Practice Manual**

Board of studies at the time of registration provides you the above two books.

3. **Suggested Answers**

After announcement of results, the suggested answers of the questions asked in that particular attempt are issued by the Board of studies.

4. **Revision Test Papers**

For every examination, Board of studies comes out with Revision Test Papers (RTP) meant for that particular attempt. However, in Accounts, you may refer RTPs of past few attempts.

5. **Mock Test Papers**

Mock Test Papers are also issued by the Board of Studies time to time. These mock test papers are based on the pattern of the question paper of the past examination.

Now, after knowing the various knowledge inputs provided by the Board of Studies, you should plan your studies accordingly. As stated earlier that all the course-ware mentioned above is not provided to you at the same time, hence one can comprehend that the objective of each knowledge input provided is different and requires your practice of the same, at different stage of your study.

How to study?

There is a very popular saying that if you fail to plan then you plans to fail. Planning is one of the essential elements for studying a subject of professional course. By planning, here we mean time management for subject as a whole and individually as well for each and every chapter. We would like to state that for the paper of accounting, one needs at least three rounds of study.

Advanced Accounting examination paper is purely practical based. Therefore, one has to do written practice of good number of questions on each topic. So, at the time of planning the study for accounting you should keep into mind the written practice of practical questions also. Considering the practical nature of the paper, start your studies from the day you receive the course material.

Keeping in mind the quantum of the syllabus, it is suggested that you should study one to two hours a day. By doing so, you will be able to manage first round of complete study and two rounds of revision well before time. Your first round of study should be completed well in advance that is at least three months before your exam. However, your planning should be based on the availability of time and the contents of the subject.

Your second round of study i.e. your first revision should be over before one month of your exam. Your second revision should be in the last month before exam so that you will be in the position to remember all the concepts. These three rounds of study will help in boosting the confidence level for the subject and will make you mentally prepared to appear in the examination.

Schedule

First round of study

Similar to the paper of Accounting, the syllabus of 'Advanced Accounting' also covers Accounting Standards as well as other topics, so here also, your planning should be divided in two parts namely-

1. Accounting Standards
2. Other chapters of the course curriculum.

Every day when you start your study first go through the concepts which you have read last day then start learning new concepts. Remember, out of sight, out of mind. Ideally your first study should be within 24 hours of initial reading, the second within 1 week of reading.

In Paper 1 'Accounting' at Intermediate (IPC) Course Group I level, we already had chapters on Partnership firm and Company accounts which dealt with some of the aspects of such form of businesses. Like in partnership, aspects of admission, retirement or death of a partner have been dealt with and the topics of company's accounts dealt with the issue of bonus shares, amalgamation, internal reconstruction etc.

The paper of 'Advanced Accounting' covers some more aspects of partnership firm and company accounts. Therefore, we in this paper recommend you to take these topics first as you are familiar with the accounting treatment followed in such types of businesses and will be in a position to grasp quickly the accounting treatment to be done for other aspects covered in this paper. However, considering the importance of these topics, unit on amalgamation and internal reconstruction has been included in this paper also.

For other topics, you may decide, at your convenience as to which topic should be taken up next and in what sequence. However, for this paper, we suggest you to study accounting standards at the end as we do not have any chapter which is specifically based on the provisions of accounting standards though accounting standards may apply in some situations like for valuation of investments of banks you may have to apply the provisions of AS 13 if nothing is specified in the Banking Regulations or the RBI Act in this regard.

Again in this paper also, we would like to re-iterate that for accounting standards, study the explanation given in chapter 2 first and then study the bare text of the accounting standard given as an appendix at the end, after chapter 9 of the study material. Following this procedure will help you in-depth understanding of the underlying concepts of accounting standards specified in the syllabus and the manner in which it is interpreted and should be interpreted.

Use of BoS Knowledge inputs in a systematic pattern

Step 1 Study material

To lay a strong foundation of the understanding of any particular topic, study material explains the concepts of each and every topic in detail with adequate illustrations. Study the underlying concepts and accounting treatment specified therein analytically before proceeding towards illustrations. Keep questioning yourself until you are absolutely clear on the topic. Solve the illustrations after understanding the topic.

Step 2 Practice Manual

After solving the illustrations given in the study material, solve the questions given in the practice manual. Practice Manual is highly useful for the students appearing in the examination as it includes questions from past examinations which would facilitate in thorough understanding of the chapters explained in the study material. In Advanced Accounting paper, it is very necessary that one should practice a good number of questions dealing with different adjustments. Practice Manual will help serve this purpose. Your first round of study should cover both Study Material and Practice Manual.

Second round of study

Step 3 Suggested answers

Your second round of study i.e. your first revision should cover practice of suggested answers of recent two to three examinations. Suggested answers of past few examinations give you an idea of what type of questions are asked in the examination and how to solve and present the solution for such questions in the examination. Solving the question paper in the examination situation will help you, not only in time management but will also give you the confidence to attempt different types of questions in the examination.

Step 4 Revision Test Papers (RTP)

After you complete revision of whole syllabus at least once, you should solve the questions given in the RTP. For every examination, Board of Studies comes out with a Revision Test Paper. Revision Test Paper is issued for every attempt containing a fresh set of questions which will help you to evaluate your preparation level. RTP of Advanced Accounting is divided into two parts namely Part I: Recent amendments, Notifications and Announcements which are relevant for that particular examination and are not given in the study material or were not applicable in the immediate past examination. You will be able to know all such relevant information applicable for the exam at one place. Part II carries questions and answers for your practice. In Advanced Accounting, questions on each topic are given with full solution to enable you to get an insight on how to present the solutions in an orderly manner. In Advanced Accounting paper, RTP of past few attempts can also be referred subject to amendments for which you have to refer the latest Study Material and RTP.

Third round of study

Step 5 Mock Test Papers

After second revision of the complete syllabus, you may assess your preparation by taking mock tests conducted by various branches at their end. Also Mock test papers are hosted on the institute's website www.icai.org which you may download and solve within a time period of three hours.

Important points to be kept in mind

1. Preparation of notes

Prepare concise notes in the first round of study itself. Your notes should be prepared in a manner, which supplements your understanding of the concept and the illustrations you have solved. You may either make a separate copy where you write down the important concepts of the chapter or can underline the important concepts in the book itself and read those underlined portion at the time of revision. You should also shortlist the illustrations to be revised again in your second and third round of study. Short listing of illustrations should be based on the difficulty you faced while solving the question. Besides preparation of important points of the topic (which will help you to recapitulate the whole concepts), a summary of tricky points and adjustments gathered from the practice of various good illustrations may also be prepared which will help in grasping the intricate practical aspects. Such tricky points or adjustments should be cross linked with the concerned illustration number so that at the time of revision you not only study the accounting treatment but also refer the whole solution again. These notes may also be accompanied by the

proforma of relevant accounts and diagrams so that at the later stages of preparation, the conceptual knowledge underlying different topics may be gained within minimum time and efforts without going through a number of books again.

2. Use of proper and prescribed format for presentation of accounts

There are some chapters which require the solution or financial statements to be presented in particular format. You should make it a practice to adopt the prescribed formats while presenting the accounts of particular entities. For example: Financial Statements of companies should be in the format prescribed in the Schedule III to the Companies Act, 2013.

3. Recapitulation of previously read topics

The chapter of Partnership accounts was also there in the paper of 'Fundamentals of Accounting' at CPT level. Therefore, here at Intermediate (IPC) Course level, you are required to whet your skills on this topic. Also the concepts and provisions read at CPT level lays down the foundation for studying and understanding the topics specified at the Intermediate (IPC) Course level. For example, concept of revenue and capital receipt and expenditure is applied in every topic while preparing the financial statements of an entity. Similarly, valuation of inventory, accounting for depreciation etc. are some of the topics the concepts of which are applied in general to all entities.

4. Keep yourself continuously updated

We at Board of studies endeavor to update you with the latest amendments or notifications as and when they are issued. One of the sections in the Students' Journal is on 'Academic Update' which contains recent amendments in accounting also. You should be in a habit to read this continuously as it will help you in avoiding last moment pressure to acquaint yourself with all the relevant amendments. Also list of publications comprising of all relevant accounting standards and guidance notes are published well in time in the Students' Journal and the institute's website to apprise you with the applicability part of the same in the particular examination.

5. Keep in mind the Inter-linking of various topics

The provisions of accounting standards have to be kept in mind and applied while studying the related chapter based on the particular accounting standard. If your concepts are clear relating to a particular standard, you should not face any problem in applying the same to solve problems in an inter-connected chapter. Sometimes even though the chapter may not directly relate to an accounting standard, it may contain adjustments involving application of one or more standards.

Tips for examination

Following are accounting related examination tips which you should keep in mind at the time of appearing for the examination:

1. Use of proper formats

Certain statutes prescribe specific formats for presentation of the accounts. You should take care of the same at the time of solving the questions in the exam. Accounts presented in the prescribed manner will help you in scoring due marks.

2. Adequate Working Notes

In accounts, your solution is generally divided in two parts viz- main solution and working notes. Working notes form part of your solution and carries marks. Therefore, it is advised that calculations made on your calculator should also be written in your answer sheet as working note, wherever required, neatly and precisely. Also your working note should be cross referenced with the figure used in the main solution so that examiner can easily understand that how you have arrived at the particular figure.

3. Answer the questions with due emphasis on the provisions of Accounting Standards

Support your answers/conclusions with proper reasoning. Answers for questions based on accounting standards should be supported with provisions of that accounting standard rather than a mere common sense or guess work. It is not required to quote paragraph number of Accounting standard but you are expected to quote accounting standard number along with the name of the standard. However, if you state, paragraph number of accounting standard, then it will add value to the solution and will also help create a good impression in the mind of the examiner. You should quote number of accounting standard or name only when you are sure. It is better not to quote than to misquote the accounting standard number.

4. State the assumption clearly

In case a question leaves room for making an assumption and there is a possibility of more than one assumption, it is important to clearly state the assumption you have taken and solve the question accordingly.

Happy Reading and Best Wishes!

SYLLABUS

GROUP II
PAPER 5: ADVANCED ACCOUNTING

(One paper – Three hours – 100 Marks)

Level of Knowledge: Working Knowledge

Objectives:

(a) To have an understanding of the framework for the preparation and presentation of financial statements,

(b) To gain working knowledge of the professional standards and application of accounting principles to different practical situations, and

(c) To gain the ability to solve advanced problems in the case of different entities.

Contents :

1. Framework for Preparation and Presentation of Financial Statements

2. Accounting Standards

Working knowledge of:

AS 4 : Contingencies and Events occurring after the Balance Sheet Date

AS 5 : Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

AS 11 : The Effects of Changes in Foreign Exchange Rates (Revised 2003)

AS 12 : Accounting for Government Grants

AS 16 : Borrowing Costs

AS 19 : Leases

AS 20 : Earnings Per Share

AS 26 : Intangible Assets

AS 29 : Provisions, Contingent Liabilities and Contingent Assets.

3. Advanced Issues in Partnership Accounts and Issues related to accounting in Limited Liability Partnerships

Dissolution of partnership firms including piecemeal distribution of assets; Amalgamation of partnership firms; Conversion into a company and Sale to a company.

4. Company Accounts

(a) Accounting for employee stock option plan, Buy back of securities, Equity shares with differential rights, Underwriting of shares and debentures, Redemption of debentures

(b) Advanced problems for business acquisition, Amalgamation and reconstruction (excluding problems of amalgamation of inter-company holding)

(c) Accounting involved in liquidation of companies, Statement of Affairs (including deficiency/surplus accounts) and liquidator's statement of account of the winding up.

(d) Financial Reporting of Insurance and Banking Companies and legal and regulatory requirements thereof

5. Accounting for Special Transactions

Departmental and branch accounts including foreign branches

Note – If either old Accounting Standards (ASs), Announcements and Limited Revisions to ASs are withdrawn or new ASs, Announcements and Limited Revisions to ASs are issued by the Institute of Chartered Accountants of India in place of existing ASs, Announcements and Limited Revisions to ASs, the syllabus will accordingly include/exclude such new developments in place of the existing ones with effect from the date to be notified by the Institute.

CONTENTS

DETAILED CONTENTS : MODULE – 1

1

Framework for Preparation and Presentation of Financial Statements

Learning Objectives

After studying this chapter, you will be able to:

- ♦ Understand the meaning and significance of Framework for the Preparation and Presentation of Financial Statements.
- ♦ Learn objectives of Financial Statements.
- ♦ Understand qualitative characteristics of Financial Statements.
- ♦ Comprehend recognition and measurement of elements of Financial Statements.
- ♦ Know concepts of capital, capital maintenance and determination of profit.

1. Introduction

The development of accounting standards or any other accounting guidelines need a foundation of underlying principles. The Accounting Standards Board (ASB) of the ICAI issued framework in July, 2000 which provides the fundamental basis for development of new standards as also for review of existing standards. The principal areas covered by the framework are as follows:

(a) Components of financial statements;

(b) Objectives of financial statements;

(c) Assumptions underlying financial statements;

(d) Qualitative characteristics of financial statements;

(e) Elements of financial statements;

(f) Criteria for recognition of elements in financial statements;

(g) Principles of measurement of financial elements;

(h) Concepts of Capital and Capital Maintenance.

2. Purpose of the Framework

The framework sets out the concepts underlying the preparation and presentation of general-purpose financial statements prepared by enterprises for external users. The main purpose of the framework is to assist:

(a) Enterprises in preparation of their financial statements in compliance with the accounting standards and in dealing with the topics not yet covered by any accounting standard.

(b) Accounting Standard Board (ASB) in its task of development and review of accounting standards.

(c) ASB in promoting harmonisation of regulations, accounting standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by accounting standards.

(d) Auditors in forming an opinion as to whether financial statements conform to the accounting standards.

(e) Users in interpretation of financial statements.

3. Status and Scope of the Framework

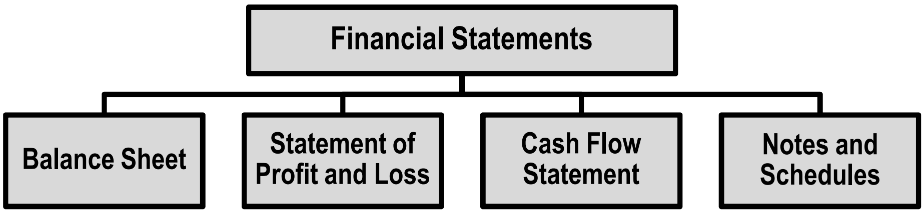
The framework applies to general-purpose financial statements (hereafter referred to as 'financial statements' usually prepared annually for external users, by all commercial, industrial and business enterprises, whether in public or private sector. The special purpose financial reports, for example prospectuses and computations prepared for tax purposes are outside the scope of the framework. Nevertheless, the framework may be applied in preparation of such reports, to the extent not inconsistent with their requirements.

Nothing in the framework overrides any specific Accounting Standard. In case of conflict between an accounting standard and the framework, the requirements of the Accounting Standard will prevail over those of the framework.

4. Components of Financial Statements

A complete set of financial statements normally consists of a Balance Sheet, a Statement of Profit and Loss and a Cash Flow Statement together with notes, statements and other explanatory materials that form integral parts of the financial statements.

All parts of financial statements are interrelated because they reflect different aspects of same transactions or other events. Although each statement provides information that is different from each other, none in isolation is likely to serve any single purpose nor can any one provide all information needed by a user.



The major information contents of different components of financial statements are explained as below:

Balance Sheet portrays value of economic resources controlled by an enterprise. It also provides information about liquidity and solvency of an enterprise which is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due.

Statement of Profit and Loss presents the result of operations of an enterprise for an accounting period.

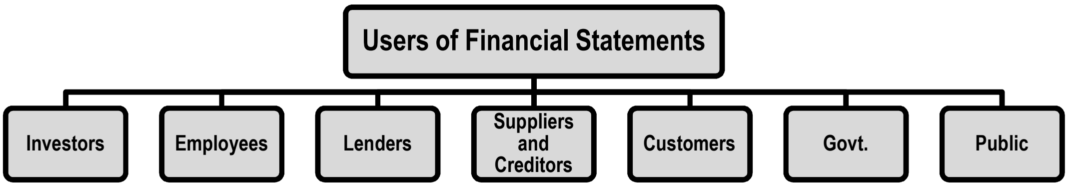
Cash Flow Statement shows the way an enterprise has generated cash and the way they have been used in an accounting period.

Notes and Schedules present supplementary information explaining different items of financial statements. They may include disclosures about the risks and uncertainties affecting the enterprise and such items as disclosure of accounting policies, segmental reports, report on operations in the process of discontinuation and so on.

5. Objectives and Users of Financial Statements

The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users.

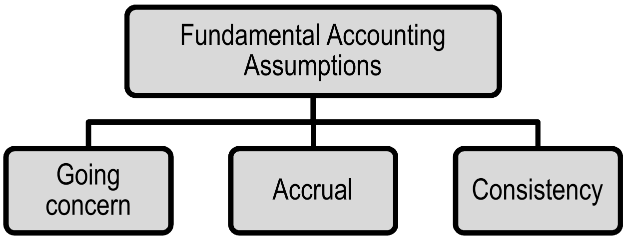
The framework identifies seven broad groups of users of financial statements.



All users of financial statements expect the statements to provide useful information needed to make economic decisions. The financial statements provide information to suit the common needs of most users. However, they cannot and do not intend to provide all information that may be needed, e.g. they do not provide non-financial data even if they may be relevant for making decisions.

6. Fundamental Accounting Assumptions

As per the framework, there are three fundamental accounting assumptions:



These are assumptions; the users of financial statements take for granted. As long as financial statements are prepared in accordance with these assumptions, no separate disclosure in financial statements would be necessary.

If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been *followed in their preparation of financial statements*.

However, if any of the above mentioned fundamental accounting assumption is not followed then this fact should be specifically disclosed.

Let us discuss these assumptions in detail.

(a) Going Concern: Financial statements are normally prepared on the assumption that an enterprise will continue in operation in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations.

Financial statements prepared on going concern basis recognise among other things the need for sufficient retention of profit to replace assets consumed in operation and for making adequate provision for settlement of its liabilities. If any financial statement is prepared on a different basis, e.g. when assets of an enterprise are stated at net realisable values in its financial statements, the basis used should be disclosed.

Example 1

Balance sheet of a trader on 31st March, 2012 is given below:

Liabilities	₹	*Assets*	₹
Capital	*60,000*	*Fixed Assets*	*65,000*
Profit and Loss Account	*25,000*	*Stock*	*30,000*
10% Loan	*35,000*	*Trade receivables*	*20,000*
Trade payables	*10,000*	*Deferred costs*	*10,000*
		Bank	*5,000*
	1,30,000		*1,30,000*

Additional information:

(a) The remaining life of fixed assets is 5 years. The pattern of use of the asset is even. The net realisable value of fixed assets on 31.03.13 was ₹ 60,000.

(b) The trader's purchases and sales in 2012-13 amounted to ₹ 4 lakh and ₹ 4.5 lakh respectively.

(c) The cost and net realisable value of stock on 31.03.13 were ₹ 32,000 and ₹ 40,000 respectively.

(d) Expenses for the year amounted to ₹ 14,900.

(e) Deferred cost is amortised equally over 4 years.

(f) Debtors on 31.03.13 is ₹ 25,000, of which ₹ 2,000 is doubtful. Collection of another ₹ 4,000 depends on successful re-installation of certain product supplied to the customer.

(g) Closing trade payable is ₹ 12,000, which is likely to be settled at 5% discount.

(h) Cash balance on 31.03.13 is ₹ 37,100.

(i) There is an early repayment penalty for the loan ₹ 2,500.

The Profit and Loss Accounts and Balance Sheets of the trader are shown below in two cases (i) assuming going concern (ii) not assuming going concern.

Profit and Loss Account for the year ended 31st March, 2013

	Case (i) ₹	Case (ii) ₹		Case (i) ₹	Case (ii) ₹
To Opening Stock	30,000	30,000	By Sales	4,50,000	4,50,000
To Purchases	4,00,000	4,00,000	By Closing Stock	32,000	40,000
To Expenses	14,900	14,900	By Trade payables	–	600
To Depreciation	13,000	5,000			
To Provision for doubtful debts	2,000	6,000			
To Deferred cost	2,500	10,000			
To Loan penalty	–	2,500			
To Net Profit	19,600	22,200			
	4,82,000	4,90,600		4,82,000	4,90,600

Balance Sheet as at 31st March, 2013

Liabilities	*Case (i)* ₹	*Case (ii)* ₹	*Assets*	*Case (i)* ₹	*Case (ii)* ₹
Capital	*60,000*	*60,000*	*Fixed Assets*	*52,000*	*60,000*
Profit & Loss A/c	*44,600*	*47,200*	*Stock*	*32,000*	*40,000*
10% Loan	*35,000*	*37,500*	*Trade receivables (less provision)*	*23,000*	*19,000*
Trade payables	*12,000*	*11,400*	*Deferred costs*	*7,500*	*Nil*
			Bank	*37,100*	*37,100*
	1,51,600	*1,56,100*		*1,51,600*	*1,56,100*

(b) Accrual Basis: Under this basis of accounting, transactions are recognised as soon as they occur, whether or not cash or cash equivalent is actually received or paid. Accrual basis ensures better matching between revenue and cost and profit/loss obtained on this basis reflects activities of the enterprise during an accounting period, rather than cash flows generated by it. Hence, accrual basis is a more logical approach for profit determination compared to cash basis of accounting.

Accrual basis exposes an enterprise to the risk of recognising an income before actual receipt. The accrual basis can therefore overstate the divisible profits and dividend decisions based on such overstated profit lead to erosion of capital. For this reason, accounting standards require that no revenue should be recognised unless the amount of consideration and actual realisation of the consideration is reasonably certain. Despite the possibility of distribution of profit not actually earned, accrual basis of accounting is generally followed because of its logical superiority over cash basis of accounting. Section 209(3)(b) of the Companies Act makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/expense is recognised on cash basis, the fact should be stated.

Example 2

(a) A trader purchased article A on credit in period 1 for ₹ 50,000.

(b) He also purchased article B in period 1 for ₹ 2,000 cash.

(c) The trader sold article A in period 1 for ₹ 60,000 in cash.

(d) He also sold article B in period 1 for ₹ 2,500 on credit.

Profit and Loss Account of the trader by two basis of accounting are shown below. A look at the cash basis Profit and Loss Account will convince any reader of the irrationality of cash basis of accounting.

Cash basis of accounting

Cash purchase of article B and cash sale of article A is recognised in period 1 while purchase of article A on payment and sale of article B on receipt is recognised in period 2.

Profit and Loss Account

		₹			₹
Period 1	*To Purchase*	*2,000*	*Period 1*	*By Sale*	*60,000*
	To Net Profit	*58,000*			
		60,000			*60,000*
Period 2	*To Purchase*	*50,000*	*Period 2*	*By Sale*	*2,500*
				By Net Loss	*47,500*
		50,000			*50,000*

Accrual basis of accounting

Credit purchase of article A and cash purchase of article B and cash sale of article A and credit sale of article B is recognised in period 1 only.

Profit and Loss Account

		₹			₹
Period 1	*To Purchase*	*52,000*	*Period 1*	*By Sale*	*62,500*
	To Net Profit	*10,500*			
		62,500			*62,500*

(c) Consistency: The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The consistency improves comparability of financial statements through time. An accounting policy can be changed if the change is required

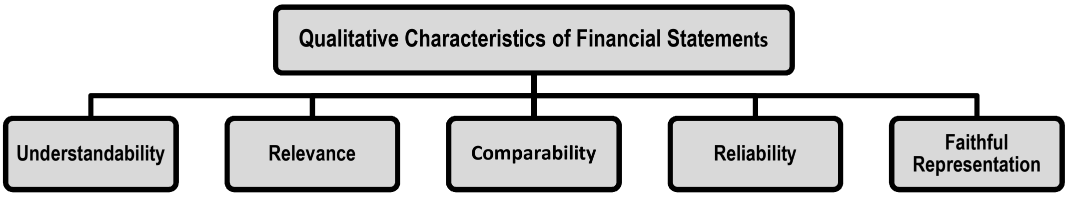
(i) by a statute or

(ii) by an accounting standard or

(iii) for more appropriate presentation of financial statements.

7. Qualitative Characteristics

The qualitative characteristics are attributes that improve the usefulness of information provided in financial statements. The framework suggests that the financial statements should observe and maintain the following five qualitative characteristics as far as possible within limits of reasonable cost/ benefit.



These attributes can be explained as:

1. **Understandability:** The financial statements should present information in a manner as to be readily understandable by the users with reasonable knowledge of business and economic activities. It is not right to think that more information one discloses the better it is. A mass of irrelevant information creates confusion and can be even more harmful than non-disclosure.

2. **Relevance:** The financial statements should contain relevant information only. Information, which is likely to influence the economic decisions by the users, is said to be relevant. Such information may help the users to evaluate past, present or future events or may help in confirming or correcting past evaluations. The relevance of a piece of information should be judged by its materiality. A piece of information is said to be material if its omission or misstatement can influence economic decisions of a user.

3. **Reliability:** To be useful, the information must be reliable; that is to say, they must be free from material error and bias. The information provided are not likely to be reliable unless:

   (a) Transactions and events reported are faithfully represented.

   (b) Transactions and events are reported in terms of their substance and economic reality not merely on the basis of their legal form. This principle is called the principle of 'substance over form'.

   (c) The reporting of transactions and events are neutral, i.e. free from bias.

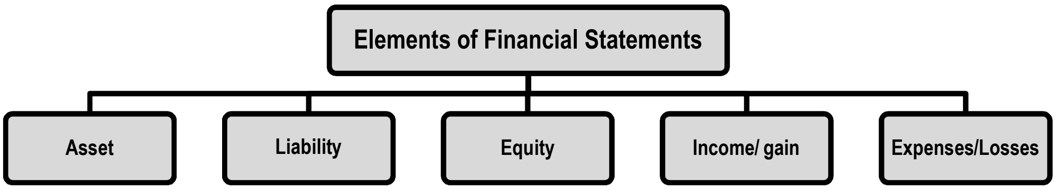
   (d) Prudence is exercised in reporting uncertain outcome of transactions or events.

4. **Comparability:** Comparison of financial statements is one of the most frequently used and most effective tools of financial analysis. The financial statements should permit both inter-firm and intra-firm comparison. One essential requirement of comparability is disclosure of financial effect of change in accounting policies.

5. **Faithful Representation (True and Fair view) :** Financial statements are required to show a true and fair view of the performance, financial position and cash flows of an enterprise. The framework does not deal directly with this concept of true and fair view, yet application of the principal qualitative characteristics and appropriate accounting standards normally results in financial statements portraying true and fair view of information about an enterprise.

8. Elements of Financial Statements

The framework classifies items of financial statements in five broad groups depending on their economic characteristics.



Gains and losses differ from income and expenses in the sense that they do not arise in the ordinary course of business. Except for the way they arise, economic characteristics of gains are same as income and those of losses are same as expenses. For these reasons, gains and losses are not recognised as separate elements of financial statements.

An item of financial element, (asset, liability, equity, expense or income) is recognised in financial statements if *both* the following criteria are met:

(a) It is probable that any future economic benefit associated with the item will flow to or from the enterprise. Concept of probability is used to ascertain the degree of uncertainty associated with the flow of economic benefits, and

(b) It has a cost or value that can be measured reliably.

In assessing whether an item of financial element meets the recognition criteria regard should be given to the materiality consideration. An item is material if misstatement or omission of the item can influence economic decision of the user. For example, an expense even if small, should be recognised if it is not tax-deductible, because one of the users of the financial statements is the taxation authority.

The recognition criteria of financial elements are inter-related. For example recognition of an asset implies that corresponding liability, income or equity should also be recognised. In other words, recognition is possible only when both of the related financial elements satisfy the specified recognition criteria. For example, in case of credit sale, the income (i.e. Sales) and asset (i.e. Debtors) can be recognised if on the basis of evidence available on balance sheet date, it is probable that the customer shall not return the goods and cash shall actually be realised.

Let us discuss each element of financial statement in detail.

1. Asset: An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. The following points must be considered while recognizing an asset:

(a) The resource regarded as an asset, need not have a physical substance. The resource may represent a right generating future economic benefit, e.g. patents, copyrights,

debtors and bills receivable. An asset without physical substance can be either intangible asset, e.g. patents and copyrights or monetary assets, e.g. debtors and bills receivable. The monetary assets are money held and assets to be received in fixed or determinable amounts of money.

(b) An asset is a resource controlled by the enterprise. This means it is possible to recognise a resource not owned but controlled by the enterprise as an asset. Such is the case of financial lease, where lessee recognises the asset taken on lease, even if ownership lies with the lessor. Likewise, the lessor does not recognise the asset given on finance lease as asset in his books, because despite of ownership, he does not control the asset.

(c) A resource cannot be recognised as an asset if the control is not sufficient. For this reason specific management or technical talent of an employee cannot be recognised because of insufficient control. When the control over a resource is protected by a legal right, e.g. copyright, the resource can be recognised as an asset.

(d) To be considered as an asset, it must be probable that the resource generates future economic benefit. If the economic benefit from a resource is expected to expire within the current accounting period, it is not an asset. For example, economic benefit, i.e. profit on sale, from machinery purchased by a machinery dealer is expected to expire within the current accounting period. Such purchase of machinery is therefore booked as an expense rather than capitalised in the machinery account. However, if the articles purchased by a dealer remain unsold at the end of accounting period, the unsold items are recognised as assets, i.e. closing stock, because the sale of the article and resultant economic benefit, i.e. profit is expected to be earned in the next accounting period.

(e) To be considered as an asset, the resource must have a cost or value that can be measured reliably.

(f) When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognised as an expense rather than as an asset.

2. Liability: A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of a resource embodying economic benefits. The following points may be noted:

(a) A liability is a present obligation, i.e. an obligation the existence of which, based on the evidence available on the balance sheet date is considered probable. For example, an enterprise may have to pay compensation if it loses a damage suit filed against it. The damage suit is pending on the balance sheet date. The enterprise should recognise a liability for damages payable by a charge against profit if possibility of losing the suit is reasonably certain and if the amount of damages payable can be ascertained with reasonable accuracy. The enterprise should create a provision for damages payable by charge against profit, if possibility of losing the suit is more than not losing it and if the amount of damages payable cannot be ascertained with reasonable accuracy. In other

cases, the company reports the damages payable as 'contingent liability', which does not meet the definition of liability. AS 29 defines provision as a liability, which can be measured only by using a substantial degree of estimation.

(b) It may be noted that certain provisions, e.g. provisions for doubtful debts, depreciation and impairment losses, represent diminution in value of assets rather than obligations. These provisions are outside the scope of AS 29 and hence should not be considered as liability.

(c) A liability is recognised only when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. Otherwise, the liability is not recognised. For example, future obligations against inventory ordered but not received) are not usually recognised as liabilities. If in some circumstances such an obligation is recognised as liability, the related asset / expense should also be recognised.

Example 3

A Ltd. has entered into a binding agreement with P Ltd. to buy a custom-made machine ₹ 40,000. At the end of 2012-13, before delivery of the machine, A Ltd. had to change its method of production. The new method will not require the machine ordered and shall be scrapped after delivery. The expected scrap value is nil.

A liability is recognised when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. In the given case, A Ltd. should recognise a liability of ₹ 40,000 to P Ltd.

When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognised as an expense rather than as an asset. In the present case, flow of future economic benefit from the machine to the enterprise is improbable. The entire amount of purchase price of the machine should be recognised as an expense. The accounting entry is suggested below:

	₹	₹
Profit and Loss Account *Dr.* *(Loss due to change in production method)*	*40,000*	
To P Ltd.		*40,000*

3. Equity: Equity is defined as residual interest in the assets of an enterprise after deducting all its liabilities. It is important to avoid mixing up liabilities with equity. Equity is the excess of aggregate assets of an enterprise over its aggregate liabilities. In other words, *equity represents owners' claim consisting of items like capital and reserves*, which are clearly distinct from liabilities, i.e. claims of parties other than owners. The value of equity may change either through contribution from / distribution to equity participants or due to income earned /expenses incurred.

4. Income: Income is increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decreases in liabilities that result in increase in equity other than those relating to contributions from equity participants. The definition of income encompasses revenue and gains. Revenue is an income that arises in the ordinary course of activities of the enterprise, e.g. sales by a trader. Gains are income, which may or may not arise in the ordinary course of activity of the enterprise, e.g. profit on disposal of fixed assets. Gains are showed separately in the statement of profit and loss because this knowledge is useful in assessing performance of the enterprise.

Income earned is always associated with either increase of asset or reduction of liability. This means, no income can be recognised unless the corresponding increase of asset or decrease of liability can be recognised. For example, a bank does not recognise interest earned on non-performing assets because the corresponding asset (increase in advances) cannot be recognised, as flow of economic benefit to the bank beyond current accounting period is not probable. Thus

Balance sheet of an enterprise can be written in form of:

A – L = E.

Where:

A = Aggregate value of asset

L = Aggregate value of liabilities

E = Aggregate value of equity

Example 4

Suppose at the beginning of an accounting period, aggregate values of assets, liabilities and equity of a trader are ₹ 5 lakh, ₹ 2 lakh and ₹ 3 lakh respectively.

Also suppose that the trader had the following transactions during the accounting period.

(a) Introduced capital ₹ 20,000.

(b) Earned income from investment ₹ 8,000.

(c) A liability of ₹ 31,000 was finally settled on payment of ₹ 30,000.

Balance sheets of the trader after each transaction are shown below:

Transactions	*Assets ₹ lakh*	–	*Liabilities ₹ lakh*	=	*Equity ₹ lakh*
Opening	*5.00*	–	*2.00*	=	*3.00*
(a) Capital introduced	*5.20*	–	*2.00*	=	*3.20*
(b) Income from investments	*5.28*	–	*2.00*	=	*3.28*
(c) Settlement of liability	*4.98*	–	*1.69*	=	*3.29*

This example given explains the definition of income. The equity increased by ₹ 29,000 during the accounting period, due to (i) Capital introduction ₹ 20,000 and (ii) Income earned ₹ 9,000 (Income from investment + Discount earned). Incomes are therefore increases in equity without introduction of capital.

Also note that income earned is accompanied by either increase of asset (Cash received as investment income) or by decrease of liability (Discount earned).

5. Expense: An expense is decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity other than those relating to distributions to equity participants. The definition of expenses encompasses expenses that arise in the ordinary course of activities of the enterprise, e.g. wages paid. Losses may or may not arise in the ordinary course of activity of the enterprise, e.g. loss on disposal of fixed assets. Losses are separately showed in the statement of profit and loss because this knowledge is useful in assessing performance of the enterprise.

Expenses are always incurred simultaneously with either reduction of asset or increase of liability. Thus, expenses are recognised when the corresponding decrease of asset or increase of liability are recognised by application of the recognition criteria stated above. Expenses are recognised in Profit & Loss A/c by matching them with the revenue generated. However, application of matching concept should not result in recognition of an item as asset (or liability), which does not meet the definition of asset or liability as the case may be.

Where economic benefits are expected to arise over several accounting periods, expenses are recognised in the profit and loss statement on the basis of systematic and rational allocation procedures. The obvious example is that of depreciation.

An expense is recognised immediately in the profit and loss statement when it does not meet or ceases to meet the definition of asset or when no future economic benefit is expected. An expense is also recognised in the profit and loss statement when a liability is incurred without recognition of an asset, as is the case when a liability under a product warranty arises.

Example *5*

Continuing with the example 4 given above, suppose the trader had the following further transactions during the period:

(a) Wages paid ₹ 2,000.

(b) Rent outstanding ₹ 1,000.

(c) Drawings ₹ 4,000.

Balance sheets of the trader after each transaction are shown below:

Transactions	*Assets ₹ lakh*	–	*Liabilities ₹ lakh*	=	*Equity ₹ lakh*
Opening	*5.00*	–	*2.00*	=	*3.00*

(a)	*Capital introduced*	*5.20*	*–*	*2.00*	*=*	*3.20*
(b)	*Income from investments*	*5.28*	*–*	*2.00*	*=*	*3.28*
(c)	*Settlement of liability*	*4.98*	*–*	*1.69*	*=*	*3.29*
(d)	*Wages paid*	*4.96*	*–*	*1.69*	*=*	*3.27*
(e)	*Rent Outstanding*	*4.96*	*–*	*1.70*	*=*	*3.26*
(f)	*Drawings*	*4.92*	*–*	*1.70*	*=*	*3.22*

The example given above explains the definition of expense. The equity decreased by ₹ 7,000 from ₹ 3.29 lakh to ₹ 3.22 lakh due to (i) Drawings ₹ 4,000 and (ii) Expenses incurred ₹ 3,000 (Wages paid + Rent).

Expenses are therefore decreases in equity without drawings. Also note that expenses incurred is accompanied by either decrease of asset (Cash paid for wages) or by increase in liability (Rent outstanding).

***Note**: The points discussed above leads us to the following relationships:*

Closing equity (CE) = Closing Assets (CA) – Closing Liabilities (CL)

Opening Equity (OE) = Opening Assets (OA) – Opening Liabilities (OL)

Capital Introduced = C

Drawings = D

Income = I

Expenses = E

$CE = OE + C + (I – E) – D$

Or $CE = OE + C + Profit – D$

Or $Profit = CE – OE – C + D$

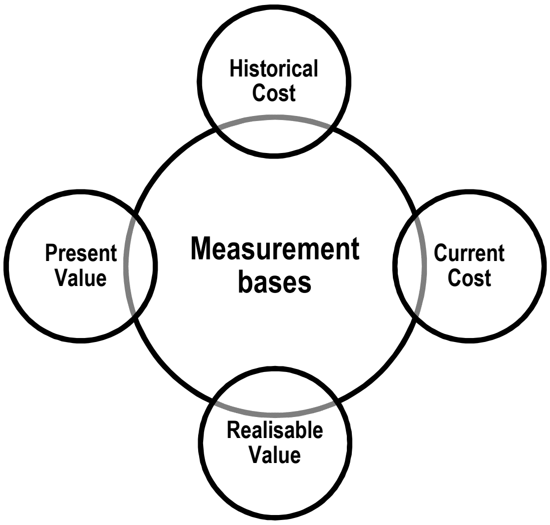
Or $Profit = (CA – CL) – (OA – OL) – C + D$

From above, one can clearly see that profit depends on values of assets and liabilities. Since historical costs are mostly used for valuation, the reported profits are mostly based on historical cost conventions. The framework recognises other methods of valuation of assets and liabilities. The point to note is that reported figures of profit change with the changes in the valuation basis. Conceptually, this is the foundation of idea of Capital Maintenance.

9. Measurement of Elements of Financial Statements

Measurement is the process of determining money value at which an element can be recognised in the balance sheet or statement of profit and loss. The framework recognises four alternative measurement bases for the purpose. These bases relate explicitly to the

valuation of assets and liabilities. The valuation of income or expenses, i.e. profit is implied, by the value of change in assets and liabilities.



In preparation of financial statements, all or any of the measurement basis can be used in varying combinations to assign money values to financial items.

A brief explanation of each measurement basis is as follows:

1. Historical Cost: Historical cost means acquisition price. For example, the businessman paid ₹ 7,00,000 to purchase the machine, its acquisition price including installation charges is ₹ 8,00,000. The historical cost of machine would be ₹ 7,00,000.

According to this, assets are recorded at an amount of cash or cash equivalent paid or the fair value of the asset at the time of acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation. In some circumstances a liability is recorded at the amount of cash or cash equivalent expected to be paid to satisfy it in the normal course of business.

When Mr. X, a businessman, takes ₹ 5,00,000 loan from a bank @ 10% interest p.a., it is to be recorded at the amount of proceeds received in exchange for the obligation. Here the obligation is the repayment of loan as well as payment of interest at an agreed rate i.e. 10%. Proceeds received are ₹ 5,00,000 - it is historical cost of the transactions. Take another case regarding payment of income tax liability. You know that every individual has to pay income tax on his income if it exceeds certain minimum limit. But the income tax liability is not settled immediately when one earns his income. The income tax authority settles it some time later, which is technically called assessment year. Then how does he record this liability? As per historical cost basis, it is to be recorded at an amount expected to be paid to discharge the liability.

Historical cost of an asset is cash or cash equivalent paid or fair value of other consideration given at the time acquisition of the asset. By historical cost convention liabilities are recorded at the amount of proceeds received in exchange of the obligation or in some cases (for example liability for income tax) the amount that is likely to be paid for settlement of liability in the normal course of business.

Example 6

Mr. X purchased a machine on 1st January, 2008 at ₹ 7,00,000. As per historical cost basis, he has to record it at ₹ 7,00,000 i.e. the acquisition price. As on 1.1.2013, Mr. X found that it would cost ₹ 25,00,000 to purchase that machine. Take also that Mr. X took loan from a bank as on 2008 ₹ 5,00,000 @ 18% p.a repayable at the end of 15th year together with interest.

As per historical cost, the liability is recorded at ₹ 5,00,000 at the amount or proceeds received in exchange for obligation and asset is recorded at ₹ 7,00,000.

2. Current Cost: Current cost gives an alternative measurement basis. Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Paragraph 80 of the Conceptual framework provides that revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the statement of profit and loss. Instead these items are included in equity as capital maintenance adjustments or revaluation reserves.

Example 7

A machine was acquired for $ 10,000 on deferred payment basis. The rate of exchange on the date of acquisition was ₹ 49/$. The payments are to be made in 5 equal annual instalments together with 10% interest per year. The current market value of similar machine in India is ₹ 5 lakhs.

		₹	₹
Machinery A/c	*Dr.*	*5,00,000*	
To Deferred Payment Obligation			*4,90,000*
To Revaluation Reserves			*10,000*

Current cost of the machine = Current market price = ₹ 5,00,000.

By historical cost convention, the machine would have been recorded at ₹ 4,90,000.

To settle the deferred payment on current date one must buy dollars at ₹ 49/$. The liability is therefore recognised at ₹ 4,90,000 ($ 10,000 × ₹ 49). Note that the amount of liability recognised is not the present value of future payments. This is because, in current cost convention, liabilities are recognised at undiscounted amount.

3. Realisable (Settlement) Value: For assets, this is the amount currently realisable on sale of the asset in an orderly disposal. For liabilities, this is the undiscounted amount expected to be paid on settlement of liability in the normal course of business. As per realisable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in *an orderly disposal*. Haphazard disposal may yield something less. Liabilities are carried at their settlement values; i.e. the undiscounted amount of cash or cash equivalents expressed to be paid to satisfy the liabilities in the normal course of business.

4. Present Value: Present value of an amount A, after n years is the amount P, one has to invest on current date to have A after n years. If the rate of interest is R then,

$A = P(1 + R)^n$

Or P (Present value of A after n years) = $\frac{A}{(1+R)^n} = A \times \frac{1}{(1+R)^n}$

The process of obtaining present value of future cash flow is called discounting. The rate of interest used for discounting is called the discounting rate. The expression $[1/(1+R)^n]$, called discounting factor depends on values of R and n.

Let us take a numerical example assuming interest 10%, A = ₹ 11,000 and n = 1 year

11,000 = 10,000(1 + 0.1)^1

Or Present value of ₹ 11,000 after 1 year = $\frac{11{,}000}{(1.10)^1} = 11{,}000 \times \frac{1}{(1.10)^1}$

Or Present value of ₹ 11,000 after 1 year = 11,000 × 0.909 = ₹ 10,000

Note that a receipt of ₹ 10,000 (present value) now is equivalent of a receipt of ₹11,000 (future cash inflow) after 1 year, because if one gets ₹ 10,000 now he can invest to collect ₹ 11,000 after 1 year. Likewise, a payment of ₹ 10,000 (present value) now is equivalent of paying of ₹ 11,000 (future cash outflow) after 1 year.

Thus if an asset generates ₹ 11,000 after 1 year, it is actually contributing ₹ 10,000 at the current date if the rate of earning required is 10%. In other words, the value of the asset is ₹ 10, 000. which is the present value of net future cash inflow it generates.

If an asset generates ₹ 11,000 after 1 year, and ₹ 12,100 after two years, it is actually contributing ₹ 20,000 (approx.) at the current date if the rate of earning required is 10% (₹ 11,000 × 0.909 + ₹ 12,100 × 0.826). In other words the value of the asset is ₹ 20,000(approx.), i.e. the present value of net future cash inflow it generates.

Under present value convention, assets are carried at present value of future net cash flows generated by the concerned assets in the normal course of business. Liabilities under this convention are carried at present value of future net cash flows that are expected to be required to settle the liability in the normal course of business.

Example 8

Carrying amount of a machine is ₹ 40,000 (Historical cost less depreciation). The machine is expected to generate ₹ 10,000 net cash inflow. The net realisable value (or net selling price) of the machine on current date is ₹ 35,000. The enterprise's required earning rate is 10% per year.

The enterprise can either use the machine to earn ₹ 10,000 for 5 years. This is equivalent of receiving present value of ₹ 10,000 for 5 years at discounting rate 10% on current date. The value realised by use of the asset is called value in use. The value in use is the value of asset by present value convention.

Value in use = ₹ 10,000 (0.909 + 0.826 + 0.751 + 0.683 + 0.621) = ₹ 37,900

Net selling price = ₹ 35,000

The present value of the asset is ₹ 37,900, which is called its recoverable value. It is obviously not appropriate to carry any asset at a value higher than its recoverable value. Thus the asset is currently overstated by ₹ 2,100 (₹ 40,000 – ₹ 37,900).

10. Capital Maintenance

Capital refers to net assets of a business. Since a business uses its assets for its operations, a fall in net assets will usually mean a fall in its activity level. It is therefore important for any business to maintain its net assets in such a way, as to ensure continued operations at least at the same level year after year. In other words, dividends should not exceed profit after appropriate provisions for replacement of assets consumed in operations. For this reason, the Companies Act does not permit distribution of dividend without providing for depreciation on fixed assets. Unfortunately, this may not be enough in case of rising prices. The point is explained below:

We have already observed: P = (CA – CL) – (OA – OL) – C + D

Where: Profit = P

Opening Assets = OA and Opening Liabilities = OL

Closing Assets = CA and Closing Liabilities = CL

Introduction of capital = C and Drawings / Dividends = D

Retained Profit = P – D = (CA – CL) – (OA – OL) – C

Or Retained Profit = Closing Equity – (Opening Equity + Capital Introduced)

A business must ensure that Retained Profit (RP) is not negative, i.e. closing equity should not be less than capital to be maintained, which is sum of opening equity and capital introduced.

It should be clear from above that the value of retained profit depends on the valuation of assets and liabilities. In order to check maintenance of capital, i.e. whether or not retained profit is negative, we can use any of following three bases:

Financial capital maintenance at historical cost: Under this convention, opening and closing assets are stated at respective historical costs to ascertain opening and closing equity. If retained profit is greater than zero, the capital is said to be maintained at historical costs. This means the business will have enough funds to replace its assets at historical costs. This is quite right as long as prices do not rise.

Example 9

A trader commenced business on 01/01/2012 with ₹ 12,000 represented by 6,000 units of a certain product at ₹ 2 per unit. During the year 2012 he sold these units at ₹ 3 per unit and had withdrawn ₹ 6,000. Thus:

Opening Equity = ₹ 12,000 represented by 6,000 units at ₹ 2 per unit.

Closing Equity = ₹ 12,000 (₹ 18,000 – ₹ 6,000) represented entirely by cash.

Retained Profit = ₹ 12,000 – ₹ 12,000 = Nil

The trader can start year 2013 by purchasing 6,000 units at ₹ 2 per unit once again for selling them at ₹ 3 per unit. The whole process can repeat endlessly if there is no change in purchase price of the product.

Financial capital maintenance at current purchasing power: Under this convention, opening and closing equity at historical costs are restated at closing prices using average price indices. *(For example, suppose opening equity at historical cost is ₹ 3,00,000 and opening price index is 100. The opening equity at closing prices is ₹ 3,60,000 if closing price index is 120).* A positive retained profit by this method means the business has enough funds to replace its assets at average closing price. This may not serve the purpose because prices of all assets do not change at average rate in real situations. For example, price of a machine can increase by 30% while the average increase is 20%.

Example 10

In the previous example (Example 9), suppose that the average price indices at the beginning and at the end of year are 100 and 120 respectively.

Opening Equity = ₹ 12,000 represented by 6,000 units at ₹ 2 per unit.

Opening equity at closing price = (₹ 12,000 / 100) x 120 = ₹ 14,400 (6,000 x ₹ 2.40)

Closing Equity at closing price

= ₹ 12,000 (₹ 18,000 – ₹ 6,000) represented entirely by cash.

Retained Profit = ₹ 12,000 – ₹ 14,400 = (-) ₹ 2,400

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund ₹ 12,000 is not sufficient to buy 6,000 units again at increased price ₹ 2.40 per unit. In fact, he should have restricted his drawings to ₹ 3,600 (₹ 6,000 – ₹ 2,400).

Had the trader withdrawn ₹ 3,600 instead of ₹ 6,000, he would have left with ₹ 14,400, the fund required to buy 6,000 units at ₹ 2.40 per unit.

Physical capital maintenance at current costs: Under this convention, the historical costs of opening and closing assets are restated at closing prices using specific price indices applicable to each asset. The liabilities are also restated at a value of economic resources to be sacrificed to settle the obligation at current, i.e. closing date. The opening and closing equity at closing current costs are obtained as excess of aggregate of current cost values of assets over aggregate of current cost values of liabilities. A positive retained profit by this method ensures retention of funds for replacement of each asset at respective closing prices.

Example 11 *(Physical capital maintenance)*

In the previous example(Example 9) suppose that the price of the product at the end of year is ₹ 2.50 per unit. In other words, the specific price index applicable to the product is 125.

Current cost of opening stock = (₹ 12,000 / 100) x 125 = 6,000 x ₹ 2.50 = ₹ 15,000

Current cost of closing cash = ₹ 12,000 (₹ 18,000 – ₹ 6,000)

Opening equity at closing current costs = ₹ 15,000

Closing equity at closing current costs = ₹ 12,000

Retained Profit = ₹ 12,000 – ₹ 15,000 = (-) ₹ 3,000

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund ₹ 12,000 is not sufficient to buy 6,000 units again at increased price ₹ 2.50 per unit. The drawings should have been restricted to ₹ 3,000 (₹ 6,000 – ₹ 3,000).

Had the trader withdrawn ₹ 3,000 instead of ₹ 6,000, he would have left with ₹15,000, the fund required to buy 6,000 units at ₹ 2.50 per unit.

Capital maintenance can be computed under all three bases as shown below:

Financial Capital Maintenance at historical costs

	₹	₹
Closing capital (At historical cost)		*12,000*
Less: Capital to be maintained		
Opening capital (At historical cost)	*12,000*	
Introduction (At historical cost)	*Nil*	*(12,000)*
Retained profit		*Nil*

Financial Capital Maintenance at current purchasing power

	₹	₹
Closing capital (At closing price)		*12,000*
Less: Capital to be maintained		

Opening capital (At closing price)	*14,400*	
Introduction (At closing price)	*Nil*	*(14,400)*
Retained profit		*(2,400)*

Physical Capital Maintenance

	₹	₹
Closing capital (At current cost)		*12,000*
Less: Capital to be maintained		
Opening capital (At current cost)	*15,000*	
Introduction (At current cost)	*Nil*	*(15,000)*
Retained profit		*(3,000)*

Summary

- **Components of Financial Statements**

Balance sheet	Portrays value of economics resources controlled by an enterprise.
Statement of Profit and loss	Presents the results of operations of an enterprise.
Cash flow statement	Shows the way an enterprise generates cash and uses it.
Notes and schedules	Presents supplementary information explaining different items

- **Users of Financial Statements**

Investors	Analysis of performance, profitability, financial position of Co.
Employees	Knowledge of stability, continuity, growth.
Suppliers, creditors	Determination of credit worthiness.
Customers	Analysis of stability, profitability.
Govt.	Evaluation of entity's performance and contribution to social objectives.

- **Fundamental Accounting Assumptions**

Accrual	Transactions are recognized as and when they occur,

	without considering receipt /payment of cash.
Going concern	Enterprise will continue in operation in foreseeable future and will not liquidate.
Consistency	Using same accounting policies for similar transactions in all accounting periods.

- **Qualitative Characteristics of Financial Statements**

Understandability	Information presented in financial statements should be readily understandable by the users with reasonable knowledge of business and economic activities.
Relevance	Financial statements should contain relevant information only. Information, which is likely to influence the economic decisions by the users, is called relevant.
Reliability	Information must be reliable; that is to say, they must be free from material error and bias.
Comparability	Financial statements should permit both inter-firm and intra-firm comparison.
True and Fair view	Financial statements should show a true and fair view of the performance, financial position and cash flows of an enterprise.

- **Elements of Financial Statements**

Asset	Resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise
Liability	Present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of a resource embodying economic benefits.
Equity	Residual interest in the assets of an enterprise after deducting all its liabilities.
Income/gain	Increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decreases in liabilities that result in increase in equity other than those relating to contributions from equity participants
Expense/loss	Decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity other than those relating to distributions to equity participants.

- **Measurement of Elements in Financial Statements**

Historical cost	Acquisition price
Current Cost	Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
Realisable (Settlement) Value	For assets, amount currently realisable on sale of the asset in an orderly disposal. For liabilities, this is the undiscounted amount expected to be paid on settlement of liability in the normal course of business.
Present Value	Assets are carried at present value of future net cash flows generated by the concerned assets in the normal course of business. Liabilities are carried at present value of future net cash flows that are expected to be required to settle the liability in the normal course of business.

- **Capital Maintenance**

Financial capital maintenance	
At historical cost	Opening and closing assets are stated at historical costs.
At current purchasing power	Restatement at closing prices using average price indices.
Physical capital maintenance	Restatement at closing prices using specific price indices.